PROBLEMS OF CLASSIFICATION UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

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Pennsylvania's adoption of the Uniform Commercial Code on April 6, 1953 has stimulated active study of its provisions by groups who had little or no hand in its preparation. One study has disclosed significant problems concerning the effect of the Code on particular transactions of importance in the field of banking. It is the purpose of this article to develop more fully one of the questions raised by this study. This question relates to the procedure which must be followed after July 1, 1954 where a loan is secured by an assignment of a real estate mortgage, of rentals under a lease of real estate, or of an interest in an estate or trust. It will also discuss the effect of the Code on a bank's right to apply a customer's deposit balance against his indebted-


2. One study group was originally formed by the Philadelphia Clearing House Association and, in collaboration with representatives of the Pittsburgh Clearing House Association and the Pennsylvania Bankers Association, has undertaken the preparation of a treatise dealing with the effect of the Code on banking operations. That treatise, Pennsylvania Banks and the Uniform Commercial Code, will be published by the Pennsylvania Bankers Association, Harrisburg, Pennsylvania, and is expected to be ready about May 1, 1954. It was written for laymen and is primarily intended to serve as a manual and guide to bank officers and employees in the day to day operations of a commercial bank. However, the interest aroused by preliminary drafts of this work, which were circulated among certain members of the bar who are interested in banking operations, has indicated that it may be of help to lawyers as well as to bank officials.

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ness to the bank, and will suggest certain possible amendments to the Code which would clarify its treatment of these topics.

The Code represents an ambitious, and it is believed successful, attempt to systematize the existing chaotic rules regarding the use of personal property as security for the payment of money or the performance of obligations. A brief description of some of the principal features of Article 9 must necessarily precede any discussion of the details of its effect on particular types of transactions.³

In Pennsylvania, as in most other states, a number of security devices had grown up with little or no logic to support them. Until comparatively recent times Pennsylvania had been perhaps the most restricted state in the Union in its recognition of security instruments. So far as tangible personal property was concerned, it originally recognized, with minor exceptions,⁴ only two security devices. The first was the common law pledge, where the creditor had possession of the goods. The second was the bailment lease. By this fictional device, used to meet economic necessity, a sale of goods with the reservation of title as security for the purchase price was upheld against other creditors of the debtor. After experimenting with certain earlier forms of conditional sale legislation,⁵ Pennsylvania adopted the Uniform Conditional Sales Act in 1925.⁶ In 1941 it adopted the Uniform Trust Receipts Act,⁷ and in 1945, in order to meet a financing need that became acute during and at the end of the war, it reversed its long-settled policy and passed a general chattel mortgage statute.⁸ Finally, in 1947, it adopted a factor’s lien act similar to those already in effect in a number of other states, but which has been used rather rarely.⁹

Pennsylvania is the first, and so far the only state to adopt the Uniform Commercial Code. Article 10 of this comprehensive statute

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³. Article 9 has been the subject of one recent treatise, and of a number of law review articles. See Birnbaum, Secured Transactions under the Uniform Commercial Code (1954) (published by the Committee on Continuing Legal Education of the American Law Institute, collaborating with the American Bar Association). See also, Freedheim and Goldston, Article 9 and Security Interests in Accounts, Contract Rights and Chattel Paper, 14 Ohio St. L.J. 69 (1953); Birnbaum, Article 9—A Restatement and Revision of Chattel Security, [1952] Wis. L. Rev. 348 (earlier articles cited at 348 n.2); Note, Article Nine—Secured Transactions, 22 Tenn. L. Rev. 848 (1953).

⁴. For example, see Pa. Stat. Ann. tit. 21, § 861 (Purdon 1930), relating to mortgages of iron ore, pig iron, etc.


repeals all of the acts mentioned above. In their place it furnishes a single and relatively simple method of financing personal property, whether the financing takes the form of a loan or a purchase and sale transaction. It adopts a completely new approach to the entire subject, eliminating all distinctions based upon the form in which a transaction is cast, and adopting a comprehensive system which is non-technical in nature.

Under the Code the practitioner will no longer have to fear some of the pitfalls which have been a serious danger in the past. There is no longer the risk that an instrument purporting to be a bailment lease will be held a conditional sale because it omits essential terms or contains words inconsistent with a lessor-lessee relationship. Nor will a chattel mortgage be defective because it is unwitnessed, as was once required, or unacknowledged, or because it is unaccompanied by a note or bond. If the Code should be adopted in other states, it would similarly dispense with requirements that must have been a nightmare to the members of the bars of those jurisdictions, who have seen conditional sale agreements and chattel mortgages held invalid because the accompanying affidavit had been attached to the contract or mortgage by some type of metal fastener rather than written on the instrument itself, or because the affidavit had been taken by an assistant cashier of a large metropolitan bank instead of by some more senior officer.

The requirements of Article 9 of the Code are extremely simple. Basically, only one of two things is required for the validity, against creditors, of a "security interest," the term the Code uses instead of the word "lien." The first alternative requirement is possession, which, in and of itself, and without the necessity of any written agreement or the filing of any statement in any public office, is sufficient to give a

17. The Code defines "security interest" as "an interest in property which secures payment or performance of an obligation." Uniform Commercial Code § 1-201(37) (Official Draft 1952) (hereinafter UCC).
creditor or other secured party a security interest which will be valid against other creditors of his debtor. Such a security interest is called by the Code a "perfected security interest." As an alternative to possession, the Code provides for the execution of a written security agreement and, in addition, provides in most cases for the filing of a financing statement in the office of the Secretary of the Commonwealth or of the local prothonotary, or both, or in the case of goods affixed or to be affixed to realty, in the office of the recorder of deeds. The formal requirements of both the security agreement and the financing statement are so simple that it is difficult to believe that anyone will suffer through his inability to comply with them.

No system, of course, can provide identical treatment for every situation which may arise and Article 9 does provide variations of procedure. However, these variations do not depend on the type of writing that is executed. Thus the procedure to be followed does not depend upon whether the parties enter into a bailment lease or a chattel mortgage, as has been the case in the past, but upon the nature of the personal property with which the parties are dealing. Accordingly, the Code divides personal property into two broad categories, tangible property and intangible property, and subdivides each of these into a number of classes.

Classification of Tangible Personal Property

Tangible personal property is referred to as "goods" and is subdivided into four classes. The first is "consumer goods," which are goods used or bought for use primarily for personal, family or household purposes. The second category is "equipment," which consists of goods used or bought for use primarily in a business, in farming or in a profession. For example, the machine tools of a manufacturer, the library of a university, or the desks and chairs of a governmental office all would constitute equipment under the Code. The third category is "farm products," which consist of crops or live-

18. UCC §§ 9-203(1) (a), 9-305(1). The Code makes an exception to this rule where goods are stored under a field warehousing or similar arrangement on the debtor's premises. UCC § 9-305(2).
20. UCC § 9-203(1) (b).
22. UCC §§ 9-401(1) (a), 9-401(1) (b).
23. UCC § 9-401(1) (c).
24. UCC § 9-105(1) (f).
25. UCC § 9-109(1).
26. UCC § 9-109(2). Goods used by a nonprofit organization or governmental subdivision or agency are also "equipment."
stock used or produced in farming operations and certain other products in their unmanufactured states, such as gin cotton, wool clip, maple syrup, milk, and eggs, provided these products are in the possession of a debtor from whose farming operations they derive or in which they are used. Finally, there is a fourth category called "inventory," which includes raw materials, work in process, finished products held for sale, and also materials used or consumed in a business, such as maintenance, repair and operating supplies.

There will be times when it may be difficult to determine into which category under the Code certain tangible personal property should be placed. A physician's automobile might be either "consumer goods" or "equipment," depending on whether it is used primarily for his family or for his practice. Similarly, it is obvious at once that a particular item of personal property may change from category to category as it passes from a manufacturer to a dealer and from him to the ultimate user. For example, a refrigerator is part of the "inventory" of the person who manufactures it or the dealer who holds it for sale. If it is purchased for use in a commercial establishment, it becomes "equipment." If, instead, it is bought for installation in a householder's kitchen, it becomes "consumer goods." These differences must be taken into account in dealing with the same item of property as it moves from one category to another.

However, no serious problems of coverage arise with respect to tangible personal property, for it is clear from the definition of "goods" that this kind of property is completely subdivided into four subclasses, leaving no residue. While it may be difficult in a few situations to decide into which class a particular article falls at a given moment, such borderline cases are inevitable. Furthermore, the parties have only a limited choice and wherever they are doubtful into which category the goods fall, they can take whatever action may be required with respect to each of the classes. For instance, there may be situations where it is doubtful whether certain goods being sold on an installment basis constitute "equipment" or "consumer goods." If they are the former, a financing statement should be filed; whereas, if they are the latter, none is required. The creditor in this situation can readily protect himself by filing as a matter of precaution, even though it may later

27. UCC § 9-109(3).
29. This is because of the catchall phrase of UCC § 9-109(2) which classifies as "equipment" all goods not included within the definition of the other three categories. UCC § 9-109(2).
30. UCC § 9-302(1).
31. UCC § 9-302(1)(d).
be decided that filing was unnecessary. Similarly, questions may arise as to where the filing should take place. It may be doubtful whether an item constitutes "farm products" or "inventory." If it is the former, only filing with the local prothonotary is necessary; \(^{32}\) but if it is the latter, there should be filing in the office of the Secretary of the Commonwealth and possibly in the office of the prothonotary as well.\(^ {33}\) In such a case the creditor should undoubtedly file in both offices.

### Classification of Intangible Personal Property

When intangible personal property is considered, however, more difficulties arise. The Code provides for five subdivisions of intangibles: "instruments," "documents," "chattel paper," "accounts," and "contract rights." In this field the draftsmen of the Code do not seem to have covered the entire field of intangible property and not only are there important subjects of financing whose classification is doubtful as between two or more of the defined categories, but there are other subjects which do not seem to fall into any category at all. This would not be serious if Section 9-102 did not lay down the rule that Article 9 applies, "... to any transaction (regardless of its form) which is intended to create a security interest in personal property ..." except as provided in Section 9-104.\(^ {34}\)

### Insurance Policies as Collateral

Certain events which occurred in the spring of 1953 illustrate the difficulties encountered in attempting to fit all intangible personal property into the five categories provided by the Code. Soon after the Code was passed, there arose the question of the status of a policy of insurance which was used as collateral for a loan.\(^ {35}\) One of the crucial ques-

\(^{32}\) UCC §9-401(1)(b).

\(^{33}\) UCC §9-401(1)(a).

\(^{34}\) UCC §9-104 originally provided:

"This Article does not apply

(a) to a security interest subject to the Ship Mortgage Act, 1920, or any other statute of the United States to the extent that such statute regulates the rights of parties to and third parties affected by transactions in particular types of property; or

(b) to a landlord's lien or a lien on real estate; or

(c) to a lien given by statute or other rule of law for services or materials except as provided in Section 9-310 on priority of such liens; or

(d) to an assignment or other transfer of a claim for wages, salary or other compensation of an employee; or

(e) to an equipment trust covering railway rolling stock; or

(f) to a transfer of accounts as part of a sale of the business out of which they arose, or a transfer of a contract right to an assignee who is also to do the performance under the contract."

\(^{35}\) The question had actually been raised earlier, at a panel discussion at the mid-winter meeting of the Pennsylvania Bar Association on January 16, 1953, but its importance was not then fully perceived, and the matter was not pressed.
tions was whether delivery of the insurance policy to the creditor perfected his security interest, or whether public filing was required. The Code provided that security interests in "documents," "chattel paper" and "instruments" could be perfected by delivery of the writing. On the other hand, security interests in "accounts" and "contract rights" were to be perfected by public filing.

Clearly, an insurance policy was neither "chattel paper" nor a "document." It did not qualify as an "account." Since it was neither a security nor a negotiable instrument, the only remaining categories which might include an insurance policy were, "any other writing" within the definition of "instrument" or "contract right." If an insurance policy was a "contract right" rather than an "instrument," a financing statement would have to be filed whenever the policy was used as collateral security for a loan, a result which the draftsmen of the Code had certainly never contemplated. There seemed no question how the draftsmen of the Code intended an insurance policy to be treated. Comment 4 to Section 9-105 stated:

"4. 'Instrument' (subsection (1)(g)): the term as defined includes not only negotiable instruments and investment securities but also other intangibles which are evidenced by writings which are in ordinary course of business transferred by delivery,

36. UCC § 9-305.
37. UCC § 9-302.
38. "'Chattel paper' means a security agreement or lease of a type which is in ordinary course of business transferred by delivery with appropriate indorsement or assignment. When a transaction is evidenced both by chattel paper and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper. . . ." UCC § 9-105(b).
40. "'Account' means a right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper. . . ." UCC § 9-106.
41. UCC § 8-102.
42. UCC § 3-104.
43. "'Instrument' means a negotiable instrument (defined in Section 3-104), or a security (defined in Section 8-102) or any other writing not itself a security agreement or lease which evidences a right to the payment of money and is of a type which is in ordinary course of business transferred by delivery. When a transaction is evidenced both by chattel paper and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper. . . ."
44. ".. . 'Contract right' means any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper. A right to wages, salary or other compensation of an employee or a right represented by a judgment is neither a 'contract right' nor an 'account.'" UCC § 9-105.
45. Most of the sections of the Code as published by its sponsors are followed by comments discussing various phases of the problem dealt with by the particular section. The Code provides in section 1-102(3)(f): "The Comments of the National Conference of Commissioners on Uniform State Laws and the American Law Institute may be consulted in the construction and application of this Act but if text and comment conflict, text controls. . . ."
for example, insurance policies. As in the case of chattel paper 'delivery' is only the minimum stated and may be accompanied by other steps."

However, it was by no means clear that they had carried out their intention. This comment showed that the draftsmen of the Code regarded an insurance policy as an "instrument," under the portion of the definition of that term which speaks of "any other writing . . . which evidences a right to the payment of money." If the draftsmen had stopped at this point there would have been no difficulty. Unfortunately, they added the words "and is of a type which is in ordinary course of business transferred by delivery." Did this mean transferred by delivery alone, as in the case of a bearer security? It was noted that in the definition of "chattel paper," the draftsmen had spoken of "a type which is in ordinary course of business transferred by delivery with appropriate indorsement or assignment" (Italics added). Lawyers were puzzled by the omission of anything corresponding to the words "with appropriate indorsement or assignment" in the definition of "instrument." This omission raised a question in their minds as to whether an insurance policy, which upon transfer is normally delivered to the transferee but which is also normally accompanied by a written assignment, met that definition, and whether various other intangibles, such as real estate bonds and mortgages, leases of real estate, and nonnegotiable commercial paper, likewise did so. It seemed possible that there was a real conflict between the text and Comment 4.

Counsel for one of the largest life insurance companies in Pennsylvania raised this problem with the sponsors of the Code soon after its approval by the Governor. He pointed out the doubt that existed as to whether a life insurance policy really was an "instrument" and if not, whether it was a "contract right," showing that it really did not fit happily under the definition of either of these terms. He suggested that if an insurance policy was an "instrument," then under the Code a person making a loan on the security of the policy would be required to obtain possession of it in order to have a perfected security interest, and that while this presented no practical difficulty where the loan was being made by a bank or other third party lender, it might cause inconvenience where the loan was being made to the policyholder by the insurance company itself, since in this situation it was not the prac-


47. The author of the memorandum believed that the so-called policy loan is no loan at all, but rather an advance, to be charged against subsequent amounts due by the company if not repaid. He argued that the insurance company in fact holds
tice of certain insurance companies to insist on the policy being delivered to or retained by them. On the other hand, he pointed out that if an insurance policy was a "contract right," rather than an "instrument," a financing statement would have to be filed and certain other undesirable consequences would follow which were never contemplated by the draftsmen of the Code. He suggested several amendments to Article 9, one of which would have changed Section 9-105(g) so as to read:

"(g) 'Instrument' means . . . or any other writing . . . which evidences a right to the payment of money and is of a type which is in ordinary course of business transferred by delivery or by delivery with appropriate indorsement or assignment."

The sponsors of the Code recognized the merit of at least part of the criticisms that had been submitted. It was decided, however, to meet the problem by excluding insurance policies entirely from the scope of Article 9, rather than by changing any of its definitions. Accordingly, the legislature amended section 9-104 by adding a new subparagraph so that it now reads:

"Section 9-104. Transactions Excluded From Article.
This article does not apply
" . . .
"(g) to an assignment or other transfer of an interest or claim in or under any policy of insurance."

While this disposed of the immediate problem of insurance policies, it still leaves the other problems of classification unsolved. The most important single category is the real estate bond and mortgage when it is used as collateral security for a loan.

Bonds and Mortgages as Collateral Security

In recent years, mortgage companies have increasingly engaged in the practice of borrowing from banks on the security of the newly created mortgages, prior to selling the bonds and mortgages to insurance companies and other investors.

No difficulty under Article 9 arises when a mortgage is originally created. Article 9 does not apply to real estate or to a lien on real

no "collateral," and that its interest in the policy is not in reality a security interest. Nevertheless, the possibility existed that some court might look upon the transaction differently.

49. UCC § 9-102.
Therefore, when an owner of real estate borrows money and executes a bond and warrant of attorney in the usual Pennsylvania form, and a mortgage on his land, Article 9 has no application. Nor does the Code come into play if the mortgagor makes an outright sale of the mortgage to some other person, since such a sale does not create a security interest in the bond or mortgage. All rights under them pass from the original mortgagor to the assignee and the mortgagor retains no right of redemption or other interest of any kind. But, as noted, frequently the mortgagor or the subsequent owner of a bond and mortgage wishes to use it as collateral security for a loan. In the past this has been a simple transaction, which was usually carried out by the execution and delivery of a collateral note evidencing the money loaned and an assignment of the bond and mortgage to the lender, and by the recording of the assignment in the office of the recorder of deeds.

Can the transaction still be handled under the Code as it was in the past? The answer is doubtful. The same factors which made for uncertainty in the case of an insurance policy are still present. There is no difficulty about the mortgage itself. That is not subject to Article 9, either because it is not personal property or because it is a lien on real estate. The trouble arises in connection with the chose in action, that is, the debt which the mortgage secures, and which is evidenced by the bond of the mortgagor. This mortgage bond is clearly personal property irrespective of the nature of the mortgage itself.

50. UCC § 9-104(b).
53. "A mortgage is a secondary—not a primary obligation. It is merely collateral security for a debt, and, without a debt, there usually can be no valid and enforceable mortgage. It was the debt owing by Michael Miller to this decedent that was intended to be appraised and not Michael Miller's real estate. The mortgage was collateral security for the payment of this debt. The debt was the bond accompanying the mortgage." Miller's Estate, 54 York Legal Rec. 133, 139 (Pa. C.P. 1940).
54. McGlathery's Estate, 311 Pa. 351, 166 Atl. 886 (1933). "Personal property, generally speaking, means, it is true, everything except real estate, and 'all my personal property' likewise would mean in general all the personal property of the testatrix which she owned at the date of her death. If the will therefore had simply given 'all my personal property' to Gertrude Graves, she would undoubtedly have been entitled to the Asbury Park mortgages, or rather the interest of the testatrix therein. . . ." Id. at 354, 166 Atl. at 887. The court, however, decided that later specific references in the will to jewelry, clothing and money showed that the testatrix did not intend to include the Asbury Park mortgage within the term "personal property" in that particular instance.
and the pledge of the bond as security for a loan is a transaction which is intended to create a "security interest in personal property," and hence falls within the basic test for the applicability of Article 9. But is filing dispensed with by delivery of the bond on the ground that it is an "instrument"? The bond is a writing which evidences a right to the payment of money, and it is neither a security agreement nor a lease. To this extent it falls within the definition of "instrument." But is it of a type which in ordinary course of business is transferred by delivery, which is one of the statutory requirements? The answer to this depends, as it did in the case of the insurance policy prior to the amendment of Section 9-104, upon the answer to another question: does delivery mean delivery alone, or delivery plus something else, namely, the execution and delivery of an assignment of the bond and mortgage?

If we assume for the moment that a mortgage bond is not an instrument, then in what category does it fall? The only other defined term in Article 9 which might apply to it is "contract right," which is defined as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper." But what is the performance which has not yet been earned by the mortgagee? It seems at least as difficult to fit the mortgage bond into the category of "contract right" as into the category of "instrument." This question of classification is of practical importance. If the mortgage bond is an "instrument," the lender can obtain a perfected security interest in it merely by taking it into his possession, and this is the only way by which he can obtain a perfected interest for a period of more than twenty-one days. On the other hand, if the bond is nothing but a "contract right," possession of the writing becomes immaterial, and a perfected security interest can be obtained only by the filing of a financing statement.

Informal discussion of this problem with proponents of the Code has produced several responses. It has been suggested that real estate bonds and mortgages are not "instruments," "documents," "chattel paper," "accounts" or "contract rights:" and hence are not subject to Article 9 at all. But this approach overlooks the very broad provi-

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55. For the definition of "instrument" see note 43 supra.
56. A security agreement is defined as an agreement which creates or provides for a security interest. UCC § 9-105(1)(h). A mortgage bond is a promise, which is void if certain conditions are fulfilled. It does not of itself create or provide for any security interest in the mortgaged property.
57. UCC § 9-106.
58. UCC § 9-305.
59. UCC § 9-304.
60. UCC § 9-302.
sions of Section 9-102, which makes Article 9 applicable to all personal property used as collateral. Irrespective of the nature of a mortgage, either as real estate or as a lien on real estate, certainly the debt which the mortgage secures is personal property in which a security interest is being created. It has also been argued that the assignment of a real estate bond and mortgage as security for a loan is not a "commercial transaction," and hence is not within the scope of the Code under any circumstances; and that to apply the Code to such a transaction would be inconsistent with its underlying purposes and policies, and would violate Article 3, Section 3 of the Pennsylvania Constitution, since the Code's title is "An Act Relating to Certain Commercial Transactions in or regarding Personal Property ...." It is true that bonds and mortgages may be assigned many times in transactions which cannot be regarded as commercial. But this is not always the case; and certainly when a commercial bank makes a loan to a customer and takes as collateral an assignment of a bond and mortgage which that customer owns, a situation which is by no means rare, the transaction can readily be regarded as a commercial one.

Therefore, as long as the possibility exists that a mortgage bond may be held to be a "contract right," there is the corresponding danger that a lender who takes such a bond and the accompanying mortgage as security for a loan and who merely follows its past practice of obtaining and recording an assignment of the bond and mortgage will be held to have an unperfected security interest in the bond. This will be vulnerable against the borrower's creditors or his trustee in bankruptcy; and if the lender's rights in the bond are subordinate to those of other persons, its rights in the mortgage may be subordinate as well. Lawyers for banks and other institutions lending on the security of bonds and mortgages may therefore feel compelled to advise their clients to take the multiple precautions of obtaining an assignment of the bond and mortgage, taking possession of the mortgage papers, and in addition filing a financing statement in the office of the Secretary of the Commonwealth, and in most instances in that of the local prothonotary as well. The alternative is to use a negotiable note instead of the customary bond, since there is no question about the status of such a note as an "instrument."

61. Lloyd, supra note 52.
63. See UCC § 1-102.
64. PA. Const. Art. 3, § 3: "No bill ... shall be passed containing more than one subject, which shall be clearly expressed in its title."
65. UCC § 9-301.
But the filing of a financing statement in connection with the transfer of a real estate bond and mortgage seems never to have been contemplated by the draftsmen of the Code and it will add nothing to the benefit received by the business community through public notice, since the assignment of the mortgage will be recorded in any event.\textsuperscript{66} It therefore seems highly probable that the Pennsylvania courts will find some method of carrying out the intention of the draftsmen by treating mortgage bonds as "instruments." They can readily do so by ignoring the difference between the words "of a type which is in ordinary course of business transferred by delivery with appropriate indorsement or assignment," which are used in the definition of "chattel paper,"\textsuperscript{67} and the words "of a type which is in ordinary course of business transferred by delivery" in the definition of "instrument."\textsuperscript{68} Or they can say that the draftsmen of the Code did intend to draw a distinction, but that they realized that chattel paper is almost always transferred both by delivery and by either indorsement or assignment, and hence that in order to qualify as "chattel paper" a writing must satisfy both of these requirements; whereas, to qualify as an "instrument" the writing must meet the requirement of delivery but need not necessarily meet the requirement of indorsement or assignment.

Nevertheless, it would seem highly desirable to remove the doubt which exists by an amendment to the definition of "instrument." This should be possible in 1955, and might take the form of the wording suggested by the insurance companies which has been quoted above,\textsuperscript{69} or the wording: "Instrument" means . . . any other writing . . . which evidences a right to the payment of money and is of a type which is in ordinary course of business transferred by delivery with or without appropriate indorsement or assignment.\textsuperscript{70}

\textbf{Security Interests in Rents}

Another type of property which is sometimes used as security for a loan is money payable as rent under a lease of real estate. Here again the Code leaves in doubt the proper treatment of such a trans-

\textsuperscript{66} Except in the case of the so-called "warehousing" or "field warehousing" of mortgages, where a bank makes a revolving credit arrangement with a mortgage company, and takes as collateral the mortgages which the latter is holding for sale to institutional investors.

\textsuperscript{67} See note 38 supra.

\textsuperscript{68} See note 43 supra.

\textsuperscript{69} See text following note 47 supra.

\textsuperscript{70} This proposal, however, will not solve the problem of a bank which is making loans secured by numerous mortgages, and which because of their volume, does not wish to record individual assignments.
action. Literally interpreted, it classifies the lease of the real estate as "chattel paper," since that term is defined as "a security agreement or lease of a type which is in ordinary course of business transferred by delivery with appropriate indorsement or assignment...."  

Furthermore, a "lease" is excluded from the definition of "instrument." It seems highly doubtful, however, that the draftsmen of the Code intended these clauses to be interpreted literally and to apply to all leases, including leases of real estate. Probably they were thinking only of leases of personal property such as bailment and other chattel leases. Nevertheless, a real estate lease and the rent payable under it are both personal property, and therefore within the broad scope of Article 9, and some classification should be provided for them.

If the lease falls within the category of "chattel paper," then the filing of a financing statement is not required for the perfection of a security interest, provided the assignee of the rentals takes possession of the written lease itself. Similarly, if the lease is treated as an "instrument," no filing is required. However, its inclusion within the term "instrument" is subject to the same doubts as those already expressed as to mortgage bonds, plus the additional doubt caused by the reference to "lease" in the definition of "instrument." Although an "account" includes the "right to payment for goods... leased," a real estate lease clearly does not fall within this definition. The inclusion of a lease, or the moneys payable under it, in the category of "contract right" would require the filing of a financing statement; but this classification is dubious. It would therefore seem desirable, in addition to amending the definition of "instrument" as suggested above, also to clarify the classification problem by specifically providing that the word "lease," as used in the definitions of "chattel paper" and "instrument," does or does not include a lease of real estate. There seems to be little choice as to which alternative should

71. UCC § 9-105(1) (b) (Italics added).
72. UCC § 9-105(1) (g).
73. UCC § 9-102(2) refers to a "bailment-lease" and "a lease intended as security." Probably only these are the leases referred to in UCC § 9-105(b) and (f). An earlier draft was clear that only a lease of goods fell within the category of chattel paper. See September 1949 Revisions, UCC § 8-106, comment 4. But "prior drafts of text and comments may not be used to ascertain legislative intent." UCC § 1-102(3) (g).
74. "A lease for years is only a chattel, or, as it is called, a chattel real; it is personal not real estate. . . ." Shaeffer v. Baeringer, 346 Pa. 32, 34, 29 A.2d 697, 698 (1943).
75. UCC § 9-305(1).
76. UCC § 9-305(1).
77. UCC § 9-106.
78. UCC § 9-302.
The important thing is to eliminate the uncertainty, which leaves a possibility that a real estate lease is neither "chattel paper" nor an "instrument," and hence is either a "contract right" or a type of intangible property for which the Code makes no specific provision. Until some change is made in the language of section 9-105 it may be necessary, as a matter of precaution, for a person lending money on the security of an assignment of rentals of real estate not only to obtain a written instrument of assignment and to give notice to the tenant, but also to file a financing statement in the appropriate offices.

**Interests in Trusts or in Decedents' Estates as Collateral**

Still another type of collateral which is sometimes assigned to a bank or other lending institution as collateral for a loan is an interest in the estate of a decedent or an interest in a trust created by will or inter vivos deed of trust. Such interests should in many or perhaps all cases be classified as personal property rather than as real estate, and hence would appear to fall within the broad scope of Section 9-102. Nevertheless, they are not embraced in any of the categories of intangible personal property established by Article 9 and it seems doubtful whether any thought was given to them in the drafting of that article. Accordingly, the appropriate method of handling such an assignment after July 1, 1954, is in doubt. Can the lender safely rely merely on the steps which he would have taken prior to that date in a similar case, such as the execution of a written assignment and notice to the personal representative, trustee or other fiduciary? It would seem unsafe for him to do so, and thereby run the risk at least of litigation if the borrower's creditors should attack the transaction, claiming that the lender had obtained only an unperfected security interest. Probably, therefore, most lenders will insist upon the filing of a financing statement. Yet this type of transaction seems to fall outside the intended scope of Article 9, which was meant to cover everyday commercial transactions; and it would seem desirable therefore to amend Section 9-104 so as to exclude specifically from Article 9 an assignment or other transfer of an interest in or claim under any decedent's estate or any trust established under a will or deed of trust.

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79. If a real estate lease is "chattel paper," a lender can obtain a perfected security interest in it by filing a financing statement, even though the lease is left in the possession of the borrower, under UCC §9-308; if it is an "instrument," possession is essential if the perfected security interest is to last for more than twenty-one days. UCC §9-304(1).

JUDGMENTS AS COLLATERAL

Occasionally, the holder of a judgment will wish to use it as collateral for a loan. If the judgment is a lien on real estate, Article 9 does not apply to it. But conceivably the judgment might be merely a claim against a solvent defendant, and therefore acceptable as collateral, without being a lien on any real property. The Code leaves in doubt the proper method of obtaining a perfected security interest in such a judgment. Normally the lender would take an assignment, and an order to mark the judgment to his use on the docket, which he would then file with the prothonotary of the court where the judgment had been entered, and would notify the defendant to make further payments to the lender as assignee. Under the Code it becomes questionable whether this is sufficient, or whether in addition a financing statement must be filed.

BANK DEPOSITS AS COLLATERAL FOR BANK LOANS

Finally, there is one other area of some importance where the Code seems deficient and where banks are vitally concerned. This is the use of deposit balances as security for moneys which a bank may lend. Many notes and agreements used by banks contain a provision that the bank is given a lien upon the deposit balance of the maker of the note as security for all of the maker's obligations to the bank.

The use of the lien concept is unnecessary in a number of situations. If the note is payable on demand, the bank has a right of set-off under the Defalcation Act, which it can ordinarily exercise at any time, even without notice to the maker of the note. Furthermore, even in the case of a time instrument, if the maker becomes a bankrupt in ordinary proceedings, the Bankruptcy Act itself gives the bank a right of set-off. On the other hand, if the bank holds a time instrument which has not matured, the bank normally has no right to seize its customer's deposit balance. It can obtain such a right only by way of contract, and the Pennsylvania courts have enforced such agreements on the theory that the bank has a "lien" on its depositor's ac-

81. UCC § 9-104(b).
84. 30 STAT. 565 (1898), as amended, 52 STAT. 878 (1938), 11 U.S.C. § 108 (1946). An exception to this general rule exists where the depositor is in reorganization proceedings under Chapter X. Susquehanna Chemical Corp. v. Producers Bank & Trust Co., 174 F.2d 783 (3d Cir. 1949).
count. 86 For example, in Southwark National Bank v. Beck, 87 the Pennsylvania Superior Court said:

"It has been uniformly held by our Supreme Court that the general rule is that demands, such as bank deposits, cannot be appropriated in satisfaction of unmatured debts, when death intervenes, or an assignment for the benefit of creditors has been filed, or receivers in bankruptcy selected, for all creditors have the right to share equally in the assets. . . . But a creditor may avoid the effect of this rule and protect himself by a contract with his debtor under which the former shall have a lien upon any fund in his hands belonging to the latter, or the right to appropriate the fund, or any part thereof, under fixed conditions, to the payment of a debt not due. This right of a bank to protect itself by such a contract was recognized by our Supreme Court in the Kurtz case and in Blum Bros. v. Girard National Bank, 248 Pa. 148, and Thompson v. Hazlewood Savings & Trust Co., 234 Pa. 452.

"In the case before us such a contract was made. While that contract did not expressly state that the bank had a lien on the deposit for the payment of the note, it did provide for the acceleration of the maturity of that obligation in the event of the death of the depositor, and that the deposit should immediately become the subject of setoff against any indebtedness due or to become due by the depositor and might at all times be held and appropriated by the bank to the payment of all notes of the depositor, matured or unmatured. In our view the agreement amounted to a pledge of the deposit and gave the plaintiff a lien thereon. . . ."

How will a Pennsylvania court treat this problem after July 1, 1954? The rule as to demand obligations seems to be unchanged by the Code. The bank's right will still depend on the Defalcation Act. 88 Likewise, the Bankruptcy Act will still control where the maker of the note becomes bankrupt and the bank may normally exercise its right of set-off in this situation, whether its note has matured or is payable on demand or at some future date. However, in a situation where neither the Defalcation Act nor the Bankruptcy Act applies, but where the bank has an agreement with its depositor that it may apply his deposit balance at any time, and hence has a contractual lien on that balance, it would seem that under the Code the bank has a security interest in the deposit account and that that security interest is subject to all the terms of Article 9. But in what category does the deposit

account fall? Here again the Code seems to be completely silent on the subject. None of the five categories of intangible personal property seems to include the deposit balance and therefore the right of the bank to apply this balance prior to the maturity of a time note may be questioned, unless the bank has filed a financing statement. The filing of such a statement would seem to be sufficient to protect the bank even though it is not possible to place the deposit account in any particular category.  

Banks will probably be reluctant to ask their customers to take this step; and their customers may well be unwilling to sign financing statements which specifically pledge their deposit balances to the bank, if the latter requests them to do so, even though the same customers have for years been signing without question printed notes and other agreements which contained a clause providing for a bankers' lien. Probably few customers read the finely printed clauses of the typical collateral note.

One alternative measure which banks can use to protect themselves is to include very broad acceleration clauses in their notes, because it seems likely that if a time note has matured through the occurrence of an accelerating event, the bank's right of set-off under the Defalcation Act will immediately come into play, and that the court will treat the note as though it were payable on demand. Some doubt may be cast on this proposition by the case of Schiff v. Schindler, where the Superior Court denied the bank's right of set-off under such circumstances. At the time that case was decided, however, Pennsylvania had not yet recognized the right of a bank to exercise its right of set-off even where it held a demand note, if it had not taken some action to apply the maker's deposit balance prior to the time some adverse claim to the deposit balance was asserted. This question soon came before the Superior Court in the case of Valiant Co. v. Pleasonton & Pa. Co. The right to set-off was denied, and this decision was affirmed by the Supreme Court of Pennsylvania in a per curiam opinion. Subsequently, Valiant Co. v. Pleasonton & Pa. Co. was overruled by the Supreme Court of Pennsylvania in the Aarons case, where the court adopted the view that the rights of the claimant

89. UCC § 9-302.

90. Although the limitations on acceleration clauses provided by UCC § 1-208 do not constitute serious obstacles, they must be taken into account in drafting any such clauses.


to the deposit balance, in that case an attaching creditor, could rise no higher than those of the depositor himself, and that since as against the depositor the bank's right of set-off was unquestionable, the bank had the same right against the attaching creditor. It is believed that the court which decided the Aarons case would probably have reached the opposite result from the Superior Court in Schiff v. Schindler. If so, a bank holding a time instrument can probably exercise its right of set-off immediately upon the happening of an accelerating event and need not fall back upon any lien theory in order to apply its customer's deposit balance.

Nevertheless, it would seem desirable for the Code specifically to cover this situation in some way. It is not believed that the draftsmen intended to change or affect any of the rules regarding set-off, and it would therefore seem appropriate to amend Section 9-104 and to provide that Article 9 shall not apply to any security interest which a bank may have in the deposit balances of its own customers.

Classification Under Article 9 in Massachusetts

In 1953 the Uniform Commercial Code was referred by the Massachusetts legislature to a special commission for the purpose of making an investigation and study. The commission recently filed its report, in which, by a vote of six to three, it recommended that the Code be enacted. Attached to the report is the text of the Code as proposed for introduction. While it is almost identical with the Code as adopted in Pennsylvania, it differs in two respects which are of particular interest in connection with the problems discussed above.

In addition to the five categories of intangible personal property found in the Pennsylvania Code, the Massachusetts bill provides for a sixth category, "general intangibles," which it defines as "intangibles other than accounts or contract rights and other than chattel paper, documents or instruments." It requires the filing of a financing statement in the office of the state secretary in order to perfect a security interest in general intangibles. It also provides that Article 9 does not apply "to a right represented by a judgment."

This last change is an excellent one for Pennsylvania to adopt. However, the creation of a sixth category of "general intangibles" in Pennsylvania would seem to create more problems than it would solve.

95. MASSACHUSETTS, ACTS AND RESOLVES OF 1953, c. 61.
98. MASS. H.R. 1928, §§ 9-302, 9-401(d).
99. MASS. H.R. 1928, § 9-104(d).
True, it would close the gap which now exists in the treatment of intangible personal property. But it would further confuse the problem arising in the case of mortgage bonds and leases, by providing still another class into which they might fall; and it would clearly include interests in estates and trusts, and bank deposits, within the scope of Article 9, from which they should be excluded. The Massachusetts bill is of great interest in its recognition of the incompleteness of the treatment of intangible property by the official draft of the Code. However, it is to be hoped that the Pennsylvania legislature will find some more satisfactory solution to the problems which have been discussed.

Conclusion

These recommendations are not intended to detract from the merits of Article 9 of the Code. Article 9 represents a forward step in the law of security, and its benefits outweigh the imperfections which have so far been discovered. It is not to be wondered that such a comprehensive revision of the law should fail to cover, or should cover in a less desirable way, a few of the transactions with which it purports to deal; or that a group of students of the Code, who had little or no connection with its original drafting, should find matters in it that they would like to change. It is believed that the Code can be improved not only in the foregoing respects but in certain others, and that as time goes on new areas of improvement will reveal themselves. The sponsors of the Code have shown an open-minded willingness to consider such suggestions as have already been made and it may be confidently expected that this attitude will continue. It is therefore to be hoped that by the winter of 1955 the points discussed in this Article, and other matters which may come to the attention of students of the Code, will be dealt with by the legislature, in order that the Code may provide an even better system for dealing with secured transactions.